

Internal Controls

*Your Eyes When You
Are Not There*

Adam H. Edelen
Auditor of Public Accounts

Overview

- ▶ Video [Brain Games №3 Excerpt.mp4](#)
- ▶ What Causes People to Commit Fraud
- ▶ Internal Controls
 - Receipts
 - Expenditures
 - Payroll
 - Computer/IT

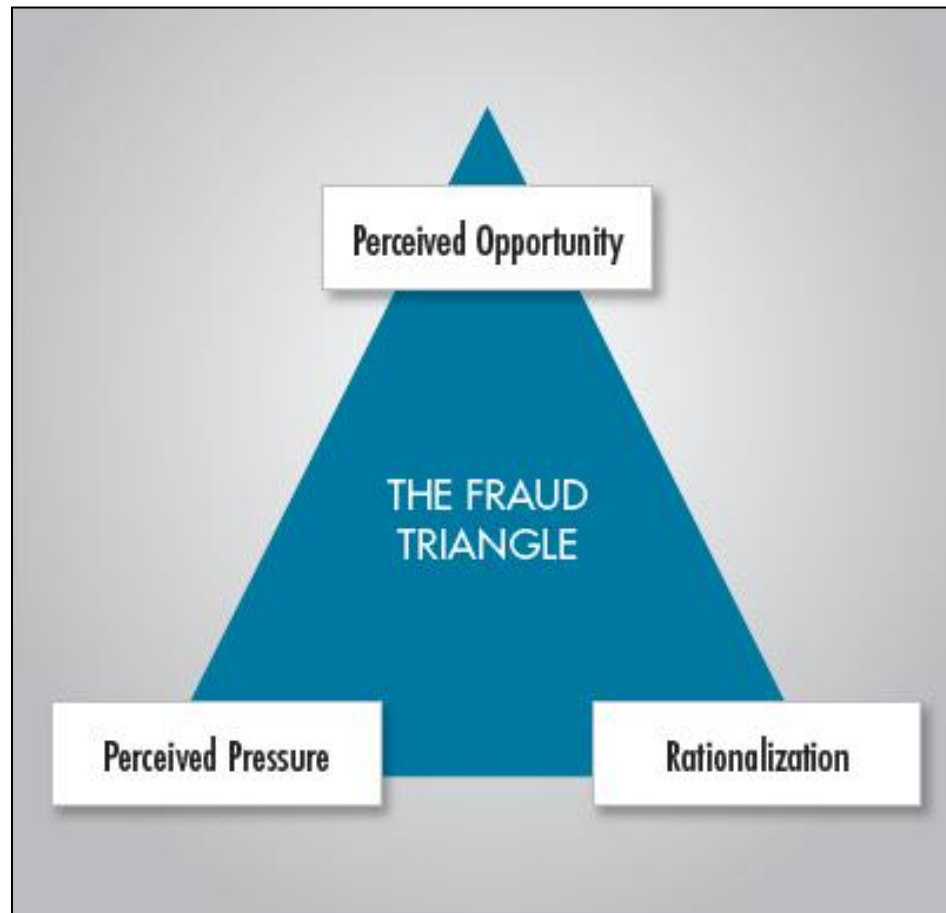
Errors and Mistakes

- ▶ Who makes errors and mistakes?

Everyone

- ▶ Good Internal Controls not only helps prevent and detect intentional fraud, on a timely basis, but also helps prevent and detect innocent errors and mistakes.

What Causes People to Commit Fraud?



What Causes People to Commit Fraud?

Pressure

- ▶ A gambling or drug habit
- ▶ Personal debt or poor credit
- ▶ A significant financial loss
- ▶ Peer or family pressure to succeed



What Causes People to Commit Fraud?

Rationalization

- ▶ *I was only “borrowing” the money and planned to repay it.*
- ▶ *The company won’t even realize this amount is gone; it’s not that much.*
- ▶ *My boss does it all the time.*

What Causes People to Commit Fraud?

Rationalization

- *I've been working with the company for 15 years. They owe it to me.*
- *I'll stop once I pay off my debts.*
- *I deserved this after the way the company has treated me.*

What Causes People to Commit Fraud?

Opportunity

- Lack of supervision
- Poor internal controls
- Poor record keeping
- Extreme trust in a single individual
- Lack of disciplinary action for previous frauds

Fraud and Its Relationship to Internal Controls

▶ **Costs of Fraud**

- *Value of lost assets*
- *Loss of public confidence in county officials*
- *Loss of reputation of the innocent*

▶ **Weak Internal Control Procedures**

- *Opportunity and temptation = potential fraudulent activity*
- *Identify specific duties and responsibilities by employee title and document who can authorize transactions*

Fraud and Its Relationship to Internal Controls

▶ **Management's Responsibilities**

- *Take reasonable steps to prevent and detect fraud by designing and maintaining an adequate system of internal controls*
- *Educate employees on the purpose and importance of internal controls*

▶ **Personnel Policies and Practices**

- *Hire qualified and honest employees for sensitive positions*
- *Perform background and reference checks for all positions handling cash and receipts*
- *Require employees who handle cash to be bonded*
- *Require employees to take annual vacations*

What Do You Control?

- ▶ You can only control:
Opportunity
- ▶ By having proper internal controls you remove the opportunity the person has.

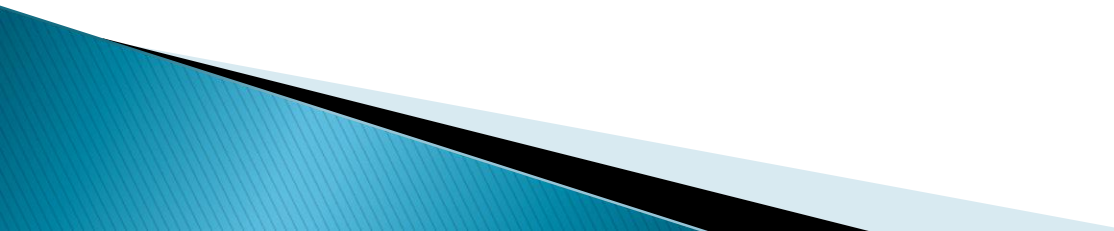


Who is Responsible for Internal Controls?

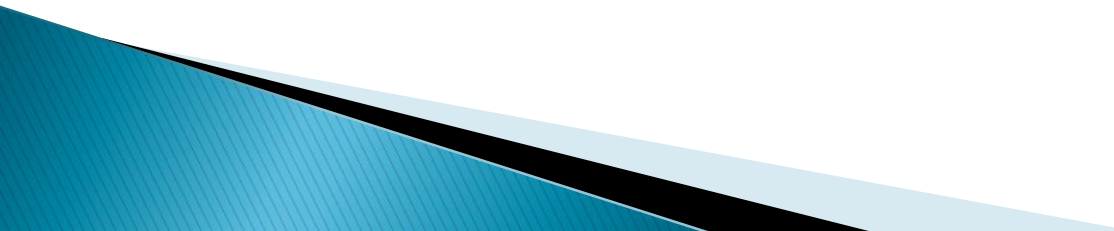


You!

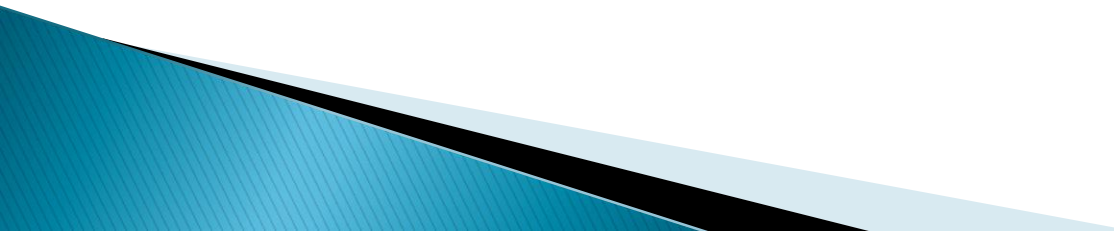
You are Responsible!

- ▶ **Management is responsible for establishing and maintaining the control environment.**
Auditors play a role in a system of internal controls by only performing evaluations and making recommendations for improved controls. Furthermore, every employee plays a role in either strengthening or weakening the Institution's internal control system. Therefore, all employees need to be aware of the concept and purpose of internal controls.
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What are Internal Controls?

- ▶ Internal controls are broadly defined as processes put in place by management, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
 - 1) Effectiveness and efficiency of operations.
 - 2) Reliability of financial reporting.
 - 3) Compliance with applicable laws and regulations.
 - 4) Protection of assets including organizational reputation.
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5 Components of Internal Control

1. Control Environment
 2. Risk Assessment
 3. Control Activities
 4. Information and Communication
 5. Monitoring
- 

Internal Controls

- ▶ In order for an internal control system to be effective, the five components of internal control must be effectively designed, implemented, and operating together in an integrated manner.

Five components of Internal Control and 17 related principles

Control Environment

1. The oversight body and management should demonstrate a commitment to integrity and ethical values.
2. The oversight body should oversee the entity's internal control system.
3. Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.
4. Management should demonstrate a commitment to recruit, develop, and retain competent individuals.
5. Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

Risk Assessment

6. Management should define objectives clearly to enable the identification of risks and define risk tolerances.
7. Management should identify, analyze, and respond to risks related to achieving the defined objectives.
8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
9. Management should identify, analyze, and respond to significant changes that could impact the internal control system.

Control Activities

10. Management should design control activities to achieve objectives and respond to risks.
11. Management should design the entity's information system and related control activities to achieve objectives and respond to risks.
12. Management should implement control activities through policies.

Information and Communication

13. Management should use quality information to achieve the entity's objectives.
14. Management should internally communicate the necessary quality information to achieve the entity's objectives.
15. Management should externally communicate the necessary quality information to achieve the entity's objectives.

Monitoring

16. Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.
17. Management should remediate identified internal control deficiencies on a timely basis.

Internal Controls

Trust

Is **NOT** an Internal Control



Types of Internal Controls

▶ **Environmental Controls**

- General controls set by statute and DLG

▶ **Management Controls**

- Specific controls put in place by Management

▶ **Control can be preventive or detective:**

- required approvals (preventive)
- segregating duties (preventive)
- securing assets (preventive)
- reconciliations (detective)
- reviews (detective)
- event notification (detective)

Management Controls

- Mandatory vacations for employees
- Authorization of transactions
- Segregation of incompatible duties
- Documentation requirements
- Access controls
- Reconciliation of underlying data
- Follow-up
- Accounting manual
- Policy manuals

What Internal Controls Do I Put In Place?

► Key Concept

1. To identify the correct **control**, you must know what **risks** are present.
2. To know what **risks** are present, you need to understand what **objectives** are being sought.



Main Operations

- ▶ Revenue
- ▶ Payroll
- ▶ Expenditures

Revenue – Objectives

- ▶ Collect receipts in a timely manner
- ▶ Document receipts daily
- ▶ Record and allocate all receipts to the proper account
- ▶ Deposit receipts promptly in the appropriate bank account
- ▶ Ensure cumulative receipts reflect amounts projected in the budget

Revenues – Sources?

Identify where and how funds are received and risk associated with each

- Mail
- In Person
- Departments
 - Occupational Tax
 - Parks and Recreation – Sports and Recreation Centers
 - Solid Waste – Landfills/Recycling Centers
 - Ambulance
 - Animal Shelter
- Jail – Inmate Booking, Housing, Medical
- Service Organizations (3rd Party Collections)
 - You cannot abdicate your responsibility
 - Must ensure Service Organization has proper controls and you are receiving everything you are entitled to

Revenue – Risks

- ▶ Money diverted for personal use
- ▶ Amount received and/or payor incorrectly recorded
- ▶ Receipts not deposited into Proper Account
- ▶ Deposits not made in a timely manner
- ▶ Receipts and deposits not recorded promptly
- ▶ Amounts recorded are incorrect
- ▶ Service Organizations – Not receiving everything that has been collected on your behalf

Revenue Internal Controls

► Examples of Internal Control Activities or Procedures:

- Ensure staff is competent and is adequately trained.
- Management samples amounts and performs a recomputation.
- Policy and procedure manuals describe revenue collection requirements.
- Promptly investigate overdue receivables and take necessary action.
- Issue Pre-numbered receipt forms
- Cashiers should use a cash register, tape, or computer.
- Ensure proper reporting from service organizations and review detailed reports and records

Revenue Internal Controls

▶ **Examples of Internal Control Activities or Procedures (Continued):**

- Incoming checks immediately receive a restrictive endorsement.
- The duties of handling and listing cash receipts, making deposits, maintaining the cash receipts journal, and posting to ledger accounts are performed by different individuals or have components reviewed by an independent party.
- Deposits should be reconciled to the daily work by a person who is independent of the receiving and recording functions.
- Bank accounts should be reconciled regularly and reviewed by someone who is independent of the cash collection and recording functions.
- Cash receipts and all related revenue accounts should be reconciled daily.
- Safes and Security Cameras

Payroll – Objectives

- ▶ Gross payroll is calculated based on the correct rate and the actual number of hours worked
- ▶ Number of hours worked are supported by properly signed time records
- ▶ Deductions and net pay are computed correctly
- ▶ Payroll expenditures are accurately recorded in the correct expenditure category
- ▶ Leave Balances are properly recorded, accounted for, and tracked
- ▶ If you use a Service Organization to process payroll
 - You cannot abdicate your responsibility
 - Must ensure Service Organization has proper controls to meet payroll objectives

Payroll– Risks

- ▶ Duplicate payments made to the same individual
- ▶ Employees paid for work not performed
- ▶ Payroll expenditures exceed amount approved by fiscal court
- ▶ Employees overpaid or underpaid
- ▶ Deductions calculated incorrectly
- ▶ Paycheck issued to wrong employee
- ▶ Paycheck issued to fictitious employee
- ▶ Payroll recorded in the wrong expenditure category
- ▶ Leave Balances are overstated or understated

Payroll – Internal Controls

► **Examples of Internal Control Activities or Procedures:**

- Cumulative payroll disbursements should be periodically compared to amounts recorded in the budget appropriation.
- Management or another designated individual verifies the availability of positions before approving an appointment.
- Payroll computations for new employees and changes in deductions of existing employees are recomputed by a second employee.
- Attendance records or time cards should be approved by a designated person.
- Attendance records or time cards should be compared to leave balance records

Payroll – Internal Controls

▶ **Examples of Internal Control Activities or Procedures (Continued):**

- Payroll checks are distributed by an employee who is independent of payroll preparation.
- The distributor of payroll checks is instructed to require identification from any employee not personally known to him or her, and is instructed to not give an employee's paycheck to someone else.
- The payroll revolving bank account is reconciled
- The monthly payroll is compared to the prior month and/or the prior year.
- Management should review payroll allocated to specific departments.
- Payroll reports and calculations by service organizations are checked for accuracy

Expenditures – Objectives

- ▶ Actual expenditures should not exceed budgeted expenditures
- ▶ Goods and services should serve the function of the Entity
- ▶ Goods and services are actually received and invoiced correctly
- ▶ Expenditures are recorded in the proper categories
- ▶ Expenditures are properly supported
- ▶ Checks are for the correct amount and to the proper payee, including taxing districts

Expenditures – Risks

- ▶ Actual expenditures exceed budget
- ▶ Goods or services ordered for personal use
- ▶ Goods or services are ordered in excessive quantities
- ▶ Goods or services ordered are not received
- ▶ Goods or services are overpriced
- ▶ Invoice does not match goods or services received or has incorrect price
- ▶ Expenditure is incorrectly recorded in the ledger or not recorded at all
- ▶ Invoice is paid twice, for wrong amount or to wrong vendor

Expenditures – Internal Controls

- ▶ **Examples of Internal Control Activities or Procedures:**
 - All purchase orders must be approved by the appropriate personnel and availability of budget appropriations/funds must be determined before issuance
 - Use pre-numbered documents (purchase orders, checks, etc.) and keep excess blank forms under the control of the clerk's designated individual.
 - Require competitive bids for larger purchases. (KRS)
 - Periodically review stale purchase orders outstanding.
 - The individual receiving goods or services must fill out a receiving report or sign a bill of lading.

Expenditures – Internal Controls

▶ **Examples of Internal Control Activities or Procedures (Continued):**

- Compare invoice prices to order prices and check for mathematical accuracy.
- One invoice is stamped “original.” Approval for payment can be made only from the original invoice.
- Cancel invoices by stamping them “PAID” once the check has been written.
- Compares the order with the receiving report and the invoice.
- The cash disbursement ledger is reconciled monthly to the bank account.

Expenditures – Internal Controls

► **Examples of Internal Control Activities or Procedures (Continued):**

- The vendor file is periodically compared and reconciled to the file of unpaid invoices.
- Budgetary records are periodically reconciled by line items to expenditure records.
- Assign the duties of approving requisitions, receiving goods or services, approving payment, preparing checks, signing checks, and preparing the bank reconciliation to different people.
- Bank reconciliation should be reviewed by someone who is independent of any other cash function.

IT Controls

▶ Some examples

- Password Policies
 - Should be strong, not something someone could guess
 - Not written down
 - Not shared
 - Changed Regularly
- Disaster Recovery Plans
 - Data should be back-up
 - Backups stored offsite
 - Anti-virus software should be up to date and working
- Levels of Access Restrictions on Applications and Files
 - Who has access to what, What can they Change
 - Access should be at lowest level needed for employee to do their job – Everyone should not have all Rights and all Access

Internal Control is a Continual Process

- ▶ Must Continually:
 - Set Proper Control Environment (Tone at the Top)
 - Evaluate Risk
 - Develop Internal Controls
 - Inform and Communicate
 - Policies and Procedures
 - Monitor and Evaluate the Effectiveness

Four Points of Failure

1. Failure to link risk and controls
2. Inadequate monitoring of controls
3. Ignoring reality – risk of management override is always present
4. Assumption it's only the auditor's job



Internal Controls and Fraud

- ▶ By having Effective and Proper Controls in Place:
 - Reduced the amount of Loss in cases by as much as 59%
 - Reduced the Duration of the fraud scheme by as much as 50%

Internal Controls Are Your “Eyes”

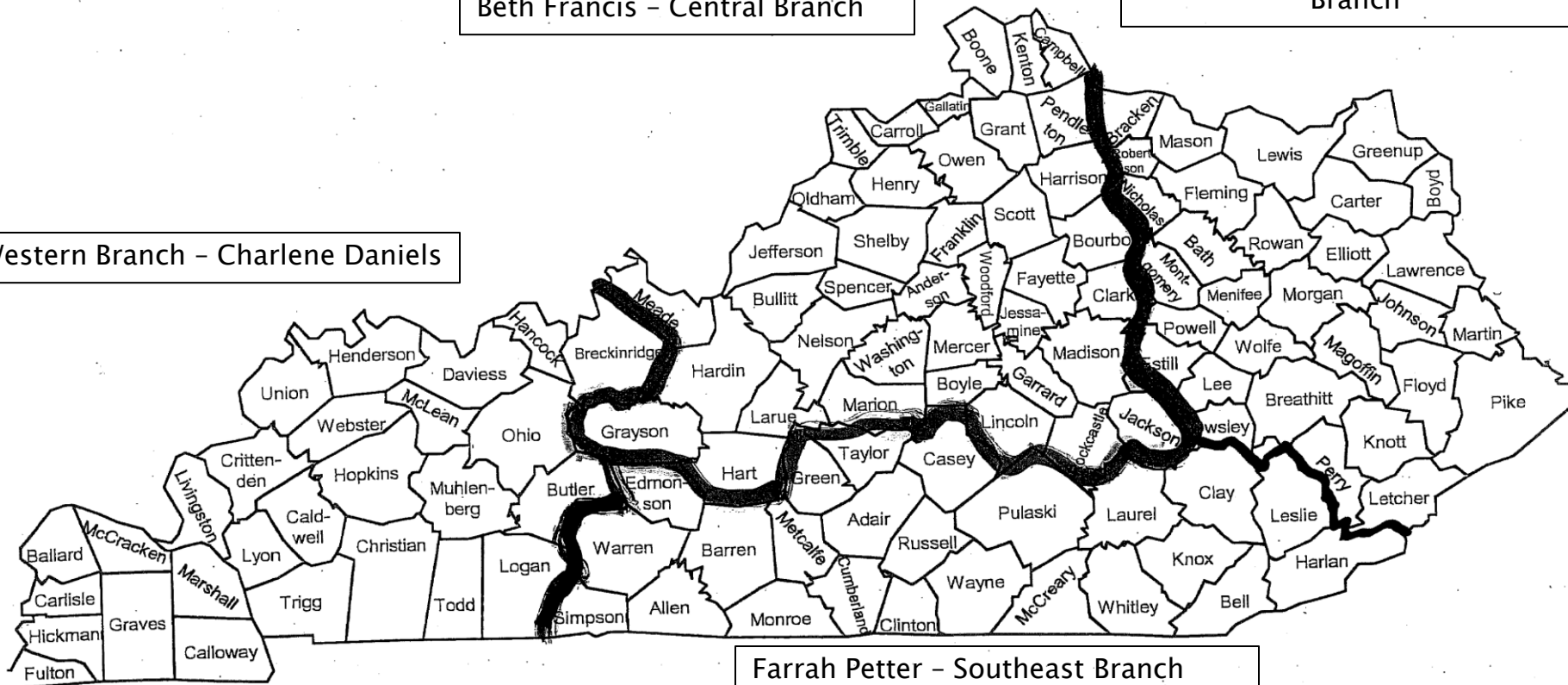


APA County Assignments

Beth Francis – Central Branch

Glen Thompson – Northeast Branch

Western Branch – Charlene Daniels



Contact Information

- ▶ Auditor of Public Accounts
 - (502) 564-5841
- ▶ Northeast Branch–Glen Thompson
 - Ext. 261 glen.thompson@ky.gov
- ▶ Central Branch–Beth Francis
 - Ext. 253 beth.francis@ky.gov
- ▶ Western Branch–Charlene Daniels
 - Ext. 212 charlene.daniels@ky.gov
- ▶ Southeastern Branch–Farrah Petter
 - Ext 219 farrah.petter@ky.gov

Contact Information

- ▶ Quality Assurance Branch Manager–Tammy Patrick
 - Ext. 274 tammy.patrick@ky.gov
- ▶ Deputy Executive Director–Jim Royse
 - Ext. 254 james.royse@ky.gov
- ▶ Assistant State Auditor – Libby Carlin
 - Ext. 200 libby.carlin@ky.gov